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No. _____

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1994

REHABILITATION SPECIALISTS, INC.

PETITIONER,

V.

SAFECO INSURANCE COMPANY OF AMERICA AND BAYTOWN CONSTRUCTION COMPANY

RESPONDENTS.

On Petition for Writ of Certiorari
to the United States Court of Appeals
for the Fifth Circuit

PETITION FOR WRIT OF CERTIORARI

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13 pp

QUESTIONS PRESENTED

1. Is a payment bond surety entitled to utilize the defenses and offsets of its principal with respect to construction projects on which the surety had absolutely no involvement and on which a principal-surety relationship did not even exist?

2. Should a payment bond claimant receive nothing from the payment bond surety when the perfected portion of the claim asserted against the bond exceeds the balance due and owing by the principal?

3. In a diversity case, does the due process clause of the Fifth Amendment to the United States Constitution require a federal court of appeals to submit a novel state law question to the proper state court for consideration when the relevant state law provides a procedure which allows such questions to be certified and sent to the state court?

4. In a diversity case involving a novel question of state law, where the relevant state has a procedure allowing the U.S. Supreme Court to certify a question to the state court, should the U.S. Supreme Court dispose of the case by certifying the state law question to the state court, and then remand the case back to the Court of Appeals with instructions to reconsider its opinion in light of the answer given by the state court?

PARTIES

Petitioner is Rehabilitative Specialists, Inc., a Florida corporation ("Rehab"). Rehab is not a parent or subsidiary of any other company. Respondents are Safeco Insurance Company of America, a Washington corporation ("Safeco"), and Baytown Construction Company, Inc., a Texas corporation ("Baytown").

TABLE OF CONTENTS

QUESTIONS PRESENTED 1

PARTIES 2

TABLE OF AUTHORITIES 4

LOWER COURT OPINIONS 7

JURISDICTION 8

CONSTITUTIONAL PROVISIONS,
STATUTES AND RULES INVOLVED 8

STATEMENT OF THE CASE 9

REASONS FOR GRANTING THE PETITION . . . 14

CONCLUSION 27

APPENDIX A A-1

APPENDIX B A-3

APPENDIX C A-36

APPENDIX D A-43

TABLE OF AUTHORITIES

CASES

Allis Chalmers Manufacturing Co. v. Curtis Electric Co., 259 S.W.2d 918 (Tex. Civ. App. - Austin 1953), ***rev'd on other grounds***, 264 S.W.2d 700 (Tex. 1954) 18

Arceneaux v. Price, 468 S.W.2d 473 (Tex. App. - Austin, no writ) 21

Argonaut Ins. Co. v. ABC Steel Door Prod. Co., Inc., 582 S.W.2d 883 (Tex. Civ. App. - Texarkana 1979, writ ref'd n.r.e.) 21

Aultman & Taylor Co. v. Hefner, 67 Tex. 54, 2 S.W. 861 (Tex. 1886) 14, 19

Bunch Electric Co. v. Tex-Craft Builders, Inc., 480 S.W.2d 42 (Tex. Civ. App. - Tyler 1972, no writ) 20

Citadel Const. Co. v. Smith, 483 S.W.2d 283 (Tex. Civ. App. - Austin 1972, writ ref'd n.r.e.) 16, 17

City of Ingleside v. Stewart, 554 S.W.2d 939 (Tex. Civ. App. - Corpus Christi 1977, writ ref'd n.r.e.) 18

City of San Antonio v. Argonaut Ins. Co., 644 S.W.2d 90 (Tex. Civ. App. - 1982, writ ref'd n.r.e.) 16

Detroit Fidelity & Surety Co. v. State, 76 S.W.2d 492 (Tex. Comm'n App., op. adopted) 20

Fidelity & Deposit Co. v. Central State Bank,
12 S.W.2d 611 (Tex. Civ. App. -
Waco 1929, no writ) 17

First State Bank v. Metropolitan Cas. Ins. Co.,
79 S.W.2d 835 (Tex. 1935) 17

Hart v. First Federal S. & L. Ass'n,
727 S.W.2d 723 (Tex. App. -
Austin 1987, no writ) 14

National Surety v. United Brick & Tile Co.,
71 S.W.2d 937 (Tex. Civ. App. -
Amarillo 1934, writ dism'd) 20, 21

O'Conner v. Metropolitan Casualty Ins. Co.,
56 S.W.2d 686 (Tex. Civ. App. -
El Paso 1933, writ dism'd) 20

Parliament Insurance Co. v. L. B. Foster,
533 S.W.2d 43 (Tex. App. - Corpus
Christi, 1976, writ ref'd n.r.e.) 17

Prairie Valley Independent School District v. Sawyer,
665 S.W.2d 606 (Tex. App. - Fort
Worth 1984, writ ref'd n.r.e.) 18

Robberson Steel, Inc. v. J.D. Abrams, Inc.,
582 S.W.2d 588 (Tex. App. -
El Paso 1979, no writ) 14, 18, 21

Trinity Universal Ins. Co. v. Woitaske,
148 S.W.2d 235 (Tex. Civ. App. -
Waco 1941, writ dism'd judgmt corr.) 20, 21

U.S. Fid. & Guar. Co. v. Henderson County,
276 S.W. 203 (Tex. Comm'n
App. 1925, jdgmt. adopted) 16

United Tile Co. v. Kermit Ind. School Dist.,
273 S.W.2d 434 (Tex. Civ. App. -
1955, writ ref'd n.r.e.) 17

Zack Burkett Co. v. Industrial Indem. Co.,
662 S.W.2d 161 (Tex. App. - 1983), writ ref'd n.r.e.,
677 S.W.2d 493 (Tex. 1984) 19

CONSTITUTIONAL PROVISIONS

U.S. Const. amend. V 8, 25

STATUTES

40 U.S.C. §270 (the "Miller Act") 15, 16, 23

Tex. Gov't Code Ann. §2253
(Vernon Supp. 1994) 15

Tex. Rev. Civ. Stat. Ann. art 5160 (Vernon 1987)
(the "McGregor Act") 11, 12, 15-18, 22, 23

Texas Rev. Civ. Stat. Ann. art. 5160(B)
(Vernon 1987) 8, 16

RULES

Tex. R. App. P. 114 (Vernon Supp. 1994) 25

Tex. R. App. P. 114(a) (Vernon Supp. 1994) 9, 24

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On Petition for Writ of Certiorari
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for the Fifth Circuit

PETITION FOR WRIT OF CERTIORARI

TO THE HONORABLE JUSTICES OF THE SUPREME COURT OF THE UNTIED STATES:

Comes Now, Rehabilitation Specialists, Inc., Petitioner, and requests the Court to issue a writ of certiorari to the Court of Appeals for the Fifth Circuit, and as grounds therefore would show the following:

LOWER COURT OPINIONS

The opinion of the Court of Appeals for the Fifth Circuit

was unpublished.[1] Rehab and Baytown timely filed a motion for rehearing, and both were denied by written order.[2] The decision of the Trial Court was unpublished, and consists of a Judgment[3], and Findings of Fact and Conclusions of Law.[4]

JURISDICTION

The opinion of the Court of Appeals was rendered on April 7, 1994. The order denying Rehab's and Baytown's motions for rehearing was rendered on May 9, 1994. This Court has jurisdiction pursuant to 28 U.S.C. 1254(1).

CONSTITUTIONAL PROVISIONS, STATUTES AND RULES INVOLVED

CONSTITUTIONAL PROVISIONS

U.S. Const. amend. V, states in relevant part:

> ...nor be deprived of life, liberty, or property, without due process of law;

STATUTES

Texas Rev. Civil Stat. Ann. art. 5160(B) (as amended in 1987), more commonly known as the McGregor Act, provides in relevant part:

> ***Rights of person furnishing labor or material. Notice required.***
>
> B. Every claimant who has furnished labor or

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1. *See*, Appendix B, p. A-3.
2. *See*, Appendix A, p. A-1.
3. *See*, Appendix D, p. A-43.
4. *See*, Appendix C, p. A-36.

> material in the prosecution of the work provided for in such contract in which a Payment Bond is furnished as required hereinabove, and who has not been paid in full therefor, shall have the right, if his claim remains unpaid after the expiration of sixty (60) days after the filing of the claim as herein required, to sue the principal and the surety or sureties on the Payment Bond jointly or severally for the amount due on the balance thereof unpaid at the time of filing the claim or of the institution of the suit plus reasonable attorneys' fees; provided: (remainder omitted)

RULES

Rule 114(a), Texas Rule of Appellate Procedure, provides as follows:

> (a) **Certification of Questions of Law.** The Supreme Court of Texas may answer questions of law certified to it by the Supreme Court of the United States or a Court of Appeals of the United States when requested by the certifying court, if there are involved in any proceeding before the certifying court questions of law of this state which may be determinative of the cause then pending and as to which it appears to the certifying court that there is no controlling precedent in the decisions of the Supreme Court of Texas. The Supreme Court may, in its discretion, decline to answer the questions certified to it.

STATEMENT OF THE CASE

FACTUAL BACKGROUND.[5] Rehab is a corporation which was

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5. This factual recitation, for the most part, is a condensed version of the relevant facts recited in the Court of Appeals opinion. See, Appendix B, p. A-5 thru A-14, for the facts as stated in the Court of

involved in the rehabilitation of water and sewer lines for municipalities. Baytown is a corporation engaged in construction work. Safeco is an insurance company which issues payment bonds to contractors.

Between 1984 and 1987, Rehab acted as a subcontractor for Baytown on at least nine separate construction projects. Safeco issued payment bonds with respect to four of these projects. Safeco had no involvement, and did not act as a surety with respect to any of the remaining five construction projects. These projects, and the bonding status on each project, are described in the following table:

Project	*Start Date*	*Safeco's Participation in Project*
4038-1	1/84	None
3981-1	1/85	None
Bacliff MUD	1/86	None
4040-1	2/86	None
3783-2 ("-2")	9/86	Payment bond issued by Safeco
3783-7 ("-7")	11/86	Payment bond issued by Safeco
3783-8 ("-8")	12/86	Payment bond issued by Safeco
3783-9 ("-9")	1/87	Payment bond issued by Safeco
4020-1	10/87	None

Between 1984 and 1986, Baytown acted as the general contractor on 4038-1, 3981-1, Bacliff MUD, and 4040-1.

Appeal's Opinion.

Rehab performed work as a subcontractor for Baytown on each of these projects. All of the work on these projects was completed. Rehab did not assert a bond claim with respect to any these projects.

During 1986 and 1987, Baytown entered into five general contracts with the City of Houston, Texas ("COH"), to wit: projects -2, -7, -8, -9, and 4020-1. All work on each of these COH projects was subcontracted to Rehab. Safeco furnished payment bonds to Baytown on four of these COH projects: -2, -7, -8, and -9 (the bonded projects). The payment bonds were issued pursuant to the McGregor Act.

During 1986, the relationship between Rehab and Baytown deteriorated. A $12 million wrongful death lawsuit was filed against Baytown and Rehab after a trench accident occurred on project -2 that resulted in the deaths of Bud Simien, a subcontractor to Rehab, and his brother. Also, an OSHA citation was issued to Baytown as a result of the accident. Baytown lost its bonding capability late in 1986 or early in 1987. Then, late in 1987, Rehab successfully bid two COH projects (3783-29 and 3783-30) on its own, without Baytown's involvement. This spelled the death knell of Baytown's commissions on any projects performed by Rehab.

After Baytown refused to pay Rehab for the remaining amount due on the five COH projects, Rehab filed claims against Safeco on the bonded projects. Baytown, as principal on the bonds, disputed Rehab's bond claims and alleged backcharges and offsets against the amount due. The backcharges and offsets related not only to the five COH projects, but also the four other projects that had been completed years earlier.

PROCEDURAL HISTORY. Safeco filed the instant suit seeking a declaration of the relative rights of the parties and questioned the validity of Rehab's bond claims. Rehab counter-

claimed against Safeco for payment of the bond claims. The parties stipulated that under the McGregor Act, Rehab had perfected $158,620.04 of its claims against the payment bonds.

Rehab also filed a cross-action against Baytown, seeking $336,743.95 under the written subcontracts on the five COH projects and $75,000 under an oral subcontract concerning 3981-1. Baytown defended Rehab's cross-action by asserting backcharges and offsets on all nine of the projects. Most of the claimed offsets (about $586,000) related to Baytown's general overhead expenses, claims costs incurred by Baytown, and amounts that Baytown paid to satisfy claims asserted by Rehab's subcontractors. Offsets were also asserted with respect to projects that Rehab believed had been closed between itself and Baytown (4038-1, 4040-1, and Bacliff MUD) for several years. The total offsets asserted by Baytown exceeded $1.25 million.

Baytown also filed a cross-action against Rehab seeking an affirmative recovery for overpayments made to Rehab. Rehab filed for bankruptcy protection under Chapter 11 after Baytown filed its cross-action against Rehab. The bankruptcy filing stayed any further prosecution of the cross-action.

After a three day bench trial, the district court entered a take nothing judgment[6] against Rehab, and awarded a $92,046.22 judgment in favor of Safeco, and against Rehab, for the attorney's fees incurred by Safeco in connection with the litigation. The district court entered findings of fact and conclusions of law.[7] The take nothing judgment was princi-

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6. See, Appendix D, p. A-43.

7. See, Appendix C, p. A-36.

pally based on a finding which allowed $726,911.50 of the offsets requested by Baytown. The result was that Baytown had overpaid Rehab a sum of $471,411.20.

On appeal, the principal issues revolved around the validity of the backcharges and offsets asserted by Baytown. Rehab challenged only $586,751.24 of the offsets allowed by the district court, and accepted the district court's allowance of $140,160.26 of disputed offsets. This conclusion reduced the maximum principal balance due to a sum of $196,583.69 ($336,743.95 less $140,160.26), plus interest and attorney's fees. Rehab concluded that since the bond claims were only perfected to the extent of $158,620.04, and Baytown was probably the only solvent defendant, it would be pointless to pursue an appeal with respect to the additional offsets allowed by the district court.

The Court of Appeals, in a thirty-five page opinion, spent thirty-two pages rejecting all of the $586,751.24 in offsets challenged on appeal, except a $39,541.08 offset for amounts paid by Baytown to Rehab's subcontractors. Accordingly, the Court of Appeals ruled that Rehab was entitled to an affirmative recovery against Baytown of $157,042.62, which represented the balance due on the bonded projects after the deduction of all lawful offsets and credits. However, in one paragraph of discussion, on an issue that was not briefed, the Court of Appeals held that Rehab should take nothing against Safeco on the bond claims, because "...as surety on the bonds, Safeco was entitled to assert all offsets alleged by its principal, Baytown," and "[t]hose offsets ($179,701.34) - which inure to Safeco's credit - clearly exceed Rehab's perfected claims against the payment bonds ($158,620.04)."

REASONS FOR GRANTING THE PETITION

1. THE COURT OF APPEALS IMPROPERLY HELD THAT SAFECO WAS ENTITLED TO CLAIM THE BENEFIT OF BAYTOWN'S OFFSETS WITH RESPECT TO PROJECTS ON WHICH SAFECO DID NOT POST A BOND AND HAD NO PARTICIPATION WHATSOEVER.

The most glaring error in the Court of Appeal's opinion was that the offsets allowed for project 4038-1 ($37,774.10) and 3981-1 ($102,386.00), a total sum of $140,160.10, were applied to reduce Rehab's perfected bond claims against Safeco. Rehab never asserted a bond claim against Safeco with respect to either of these two projects. The dispute between Rehab and Baytown with respect to 4038-1 and 3981-1 did not involve Safeco. In fact, Safeco never even posted a payment bond on either of these two projects. The record does not contain any evidence that a payment bond was ever posted by Baytown, Safeco or any other surety with respect to 4038-1 and 3981-1. In short, Safeco was a complete stranger with respect to the activities that occurred on 4038-1 and 3981-1, and had nothing to do with these projects.

The Court of Appeal's allowance of offsets to Safeco was based upon the general proposition that a surety is entitled to assert all defenses and offsets asserted by the principal.[8] Rehab agrees with this general proposition of law. This legal principle is well established, and makes good sense. However, in the present case, this rule simply can not apply to offsets pertaining to 4038-1 and 3981-1. A principal and surety relationship did not exist between Baytown and

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8. ***Aultman & Taylor Co. v. Hefner***, 67 Tex. 54, 62, 2 S.W. 861, 864 (Tex. 1886); ***Robberson Steel, Inc. v. J.D. Abrams, Inc.***, 582 S.W.2d 588, 564-65 (Tex. App. - El Paso 1979, no writ); ***Hart v. First Federal S. & L. Ass'n***, 727 S.W.2d 723, 725 (Tex. App. - Austin 1987, no writ).

Safeco with respect to 4038-1 and 3981-1. Since Safeco did not act as a surety on these projects, Baytown was not Safeco's principal, and no bond claims were ever even asserted concerning these projects, the rule allowing a surety to utilize the offsets of its principal can not apply to offsets on 4038-1 and 3981-1. Safeco should not be permitted to benefit from offsets allowed with respect to projects on which it had no involvement. With respect to at least $140,160.10 in offsets used to reduce Safeco's liability, the Court of Appeal's ruling is plainly and clearly wrong.

2. THE COURT OF APPEALS IMPROPERLY HELD THAT REHAB SHOULD TAKE NOTHING FROM SAFECO BECAUSE THE PERFECTED PORTION OF REHAB'S BOND CLAIMS EXCEEDED THE BALANCE DUE AND OWING BY BAYTOWN.

(a) The Express Language and Underlying Policy of the McGregor Act Supports Rehab's Argument.

The McGregor Act[9] is the payment bond statute which mandates the issuance of a payment bond on Texas state, county and municipal construction projects, and provides unpaid subcontractors and suppliers with a remedy to recover their unpaid bills. The McGregor Act is the Texas state counterpart to the Miller Act,[10] the federal payment bond statute dealing with federal construction projects.[11]

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9. Tex. Rev. Civ. Stat. Ann. art 5160 (Vernon 1987). The statute was amended prior to trial in February, 1993. However, the 1987 version of the statute applied to this case since all of the relevant facts occurred during or before July, 1987. In 1993, as part of Texas' effort to codify its statutes, the Texas Legislature repealed the statute and enacted a non-substantive revision at Tex. Gov't Code Ann. §2253, et. seq. (Vernon Supp. 1994).

10. 40 U.S.C. §270.

11. The language dealing with the rights of a claimant to recover under

The McGregor Act states that the claimant may recover from the:

> "... principal and surety or sureties on the Payment Bond **jointly and severally** for the **amount due on the balance thereof unpaid** at the time of filing the claim or the institution of the suit. (emphasis added)"[12]

The statutory language provides the key to the proper application of offsets. To find the "*balance thereof unpaid* at the time of filing," you must first deduct the offsets from the amount of the claim. Obviously, you can not determine the "*balance thereof unpaid*" without first deducting all lawful offsets. The express language of the statute, by providing for joint and several liability for the "balance thereof unpaid," mandates that the liability of the principal and surety be coextensive, at least to the extent of the perfected portion of the bond claim.

It is an established principle that the McGregor Act must be accorded a liberal interpretation.[13] The provisions of the McGregor Act are by operation of law incorporated into and become part of all bonds executed by a general contractor for a public works project.[14] An established rule also

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the McGregor Act, is almost identical to the corollary provision contained in the Miller Act, which also provides that an unpaid claimant "...shall have the right to sue on such payment bond for the **amount, or the balance thereof, unpaid at the time of institution of such suit** and to prosecute said action to final execution and judgment for the sum or sums justly due him:" 40 U.S.C. §270b.

12. Tex. Rev. Civ. Stat. Ann. Art. 5160(B)(Vernon 1987).

13. ***Citadel Const. Co. v. Smith***, 483 S.W.2d 283, 288 (Tex. Civ. App. - Austin 1972, writ ref'd n.r.e.); ***U.S. Fid. & Guar. Co. v. Henderson County***, 276 S.W. 203, 206 (Tex. Comm'n App. 1925, jdgmt. adopted).

14. ***City of San Antonio v. Argonaut Ins. Co.***, 644 S.W.2d 90, 91 (Tex.

holds that all doubts in the construction of a McGregor Act payment bond must be resolved against the surety.[15] The design of the McGregor Act, as a whole, expresses a legislative intent that the surety, together with the principal, be held liable to a subcontractor for the reasonable value of the *balance unpaid* on the contract at the time of making the claim, with allowance for prior payments.[16]

In the present case, the Court of Appeals found that the "amount due on the balance thereof unpaid at the time of filing" was $157,042.62. The express terms of the McGregor Act, which are incorporated into the bonds by reference, mandate that Baytown and Safeco are jointly and severally liable to Rehab for the "balance thereof unpaid." The only limit to Safeco's liability under the bonds is the perfected amount of the bond claims ($158,620.04). Since the perfected portion of the bond claims exceed the "balance thereof unpaid," Rehab should have recovered the full amount of the balance due against Safeco under the payment bonds. If there is any doubt as to how to apply the offsets, the established public policy requires the Court to liberally interpret the statute, and resolve the doubt in favor of Rehab.

The purpose of the McGregor Act and the bond is to

Civ. App. - 1982, writ ref'd n.r.e.); ***United Tile Co. v. Kermit Ind. School Dist.***, 273 S.W.2d 434, 437 (Tex. Civ. App. - 1955, writ ref'd n.r.e.).

15. ***Parliament Insurance Co. v. L. B. Foster***, 533 S.W.2d 43, 49 (Tex. App. - Corpus Christi, 1976, writ ref'd n.r.e.); ***First State Bank v. Metropolitan Cas. Ins. Co.***, 79 S.W.2d 835, 840 (Tex. 1935); ***Fidelity & Deposit Co. v. Central State Bank***, 12 S.W.2d 611, 613 (Tex. Civ. App. - Waco 1929, no writ).

16. ***Citadel Construction Co. v. Smith***, 483 S.W.2d 283, 288 (Tex. Civ. App. - Austin 1972, writ ref'd n.r.e.).

protect persons furnishing labor or material on public projects and provide a substitute for the lien laws.[17] The method of applying offsets used in the Court of Appeal's opinion (i.e. applying offsets first to reduce the perfected portion of the claim) frustrates this established policy, and runs counter to the express language of the statute. The current judgment of the Court of Appeals leaves Rehab with an uncollectible judgment against an insolvent general contractor. This is exactly the situation that the McGregor Act and all similar payment bond statutes were designed to prevent. The application of offsets made in the Court of Appeal's opinion can hardly be termed a "liberal interpretation" of the McGregor Act.

Rehab has attempted to locate all Texas cases dealing with the use of a principal's defenses and offsets by a surety or guarantor. In every case dealing with this issue, including the cases cited by the Court of Appeals in support of its ruling, the courts have held the liability of the principal to be coextensive with the liability of the surety. For example, in ***Robberson Steel, Inc. v. J.D. Abrams, Inc.***,[18] the trial court entered judgment against the principal and surety for the net amount due the principal. The liability of the principal and surety was coextensive. The creditor objected to the offset allowed to the surety because the surety did not file a motion requesting the offset. The appellate court over-

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17. ***City of Ingleside v. Stewart***, 554 S.W.2d 939, 945 (Tex. Civ. App. - Corpus Christi 1977, writ ref'd n.r.e.)(the purpose of the bond is to protect unpaid persons; not the government); ***Prairie Valley Independent School District v. Sawyer***, 665 S.W.2d 606, 611 (Tex. App. - Fort Worth 1984, writ ref'd n.r.e.); ***Allis Chalmers Manufacturing Co. v. Curtis Electric Co.***, 259 S.W.2d 918, 921 (Tex. Civ. App. - Austin 1953), ***rev'd on other grounds***, 264 S.W.2d 700 (Tex. 1954).

18. 582 S.W.2d 588, 565 (Tex. App. - El Paso 1979, no writ).

ruled this contention because the offset automatically accrued to the benefit of the surety. The coextensive liability of the principal and surety was upheld. Likewise, in ***Aultman & Taylor Co. v. Hefner***,[19] a creditor sued the maker and guarantor on a promissory note. The maker defended on the ground that the machinery received in exchange for the note was defective. The trial court entered a take nothing judgment for both the maker and guarantor. The appellate court found that the breach of warranty defense was available to both the maker and guarantor. Again, the take nothing liability of the maker and guarantor was coextensive, and this holding was upheld. Finally, in ***Zack Burkett Co. v. Industrial Indem. Co.***,[20] the principal filed for bankruptcy after the lawsuit was filed. The creditor received $18,354 as a result of the bankruptcy proceeding. The trial court failed to credit the judgment against the surety for the bankruptcy proceeds. The appellate court reformed the trial court judgment to allow for the credit. Again, the reformed judgment resulted in coextensive liability of the principal and surety. None of these cases support the allocation of offsets made by the Court of Appeals. On the contrary, these cases support Rehab's position.

Rehab has been unable to locate any case authority whatsoever that would justify an allocation of offsets in the manner provided in the Court of Appeal's opinion. The only known Texas cases that do not provide for coextensive liability of the principal and surety are cases in which the balance due on the claim exceeded the perfected portion of the bond

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19. 67 Tex. 54, 62, 2 S.W. 861, 864 (1886).

20. 662 S.W.2d 161 (Tex. App. - 1983), writ ref'd n.r.e., 677 S.W.2d 493 (Tex. 1984).

claim.[21] In these fact situations, the courts have always al-

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21. ***National Surety v. United Brick & Tile Co.***, 71 S.W.2d 937, 940-2 (Tex. Civ. App. - Amarillo 1934, writ dism'd)(A supplier sued the general contractor and surety for material furnished to the general contractor. The statutory notice was filed more than 90 days after all material was delivered. The trial court judgment was reformed on appeal to $189, reducing the judgment against the surety to the perfected amount of the claim; i.e. the amount of material delivered within the 90 day time period.)

Trinity Universal Ins. Co. v. Woitaske, 148 S.W.2d 235, 237 (Tex. Civ. App. - Waco 1941, writ dism'd judgmt corr.)(The trial court entered judgment in favor of a supplier against the general contractor and surety for $776.41. The appellate court reversed the judgment to the extent of $721.96, because this material was delivered more than 90 days before notice letter was sent to the surety. The claim was perfected for a sum of $54.45, which was the value of material delivered within the 90 day time period.)

Bunch Electric Co. v. Tex-Craft Builders, Inc., 480 S.W.2d 42, 46 (Tex. Civ. App. - Tyler 1972, no writ)(A subcontractor sued the general contractor and surety on a claim for unpaid work. The trial court entered judgment against the general contractor but entered take nothing judgment against surety. The judgment was affirmed because the subcontractor did not send a timely notice and failed to perfect any portion of the bond claim.)

O'Conner v. Metropolitan Casualty Ins. Co., 56 S.W.2d 686, 687-8 (Tex. Civ. App. - El Paso 1933, writ dism'd)(A subcontractor sued a general contractor and surety. The subcontractor recovered against the general contractor, but recovery against the surety was denied. The ruling was based upon the fact that the subcontractor failed to give the notice required by the McGregor Act, and accordingly failed to perfect any portion of the bond claim.)

Detroit Fidelity & Surety Co. v. State, 76 S.W.2d 492, 493-4 (Tex. Comm'n App., op. adopted)(A subcontractor sued the general contractor and surety. The trial court entered judgment against the general contractor for the amount due, but denied recovery against the surety. The trial court's judgment was upheld on appeal because the subcontractor failed

lowed a recovery against the surety at least to the extent that the bond claim was perfected.[22] The present case is distinguishable because in the present case, the perfected portion of the claim exceeds the balance due.

(b) General Principles of Suretyship Law Also Support Rehab's Argument

An elementary principal of suretyship law provides that the liability of a surety is coextensive with that of the principal.[23] The liability of the surety is ordinarily measured by the liability of the principal if there is no provision in the contract to the contrary.[24] The rule allowing the surety to utilize all defenses and offsets of the principal was developed to facilitate this broader principle. Obviously, it would be unfair and absurd to allow a creditor to recover the full amount of a claim asserted against a surety, but limit the liability of the principal. To hold otherwise would allow the creditor a double recovery.[25] For example, assume that a

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to perfect any portion of the claim by giving timely notice to the surety.)

22. See the annotations contained in footnote 21 to ***National Surety v. United Brick & Tile Co.***, 71 S.W.2d 937, 940-2 (Tex. Civ. App. - Amarillo 1934, writ dism'd) and ***Trinity Universal Ins. Co. v. Woitaske***, 148 S.W.2d 235, 237 (Tex. Civ. App. - Waco 1941, writ dism'd judgmt corr.).

23. ***Argonaut Ins. Co. v. ABC Steel Door Prod. Co., Inc.***, 582 S.W.2d 883, 886 (Tex. Civ. App. - Texarkana 1979, writ ref'd n.r.e.).

24. ***Arceneaux v. Price***, 468 S.W.2d 473, 474 (Tex. App. - Austin, no writ).

25. ***Robberson Steel, Inc. v. J.D. Abrams, Inc.***, 582 S.W.2d 588, 565 (Tex. App. - El Paso 1979, no writ)("But Argonaut is liable under its payment bond only for the sums owed and unpaid by Abrams. Thus, the offset which was obtained by Abrams necessarily accrued to Argonaut when final judgment was entered for the net amount owed by Abrams to Robberson. To hold otherwise would allow Robberson a double

creditor asserts a payment bond claim against the principal and his surety for $100,000. If the principal has an offset of $50,000 available, it would be unfair to enter judgment against the principal for $50,000, and enter judgment against the surety for the entire $100,000 claim. This example is the typical fact pattern in cases allowing the surety to utilize the defenses and offsets of the principal.[26]

In determining that Rehab should recover nothing from Safeco, the Court of Appeals held that:

> Those offsets ($179,701.34) - which inure to Safeco's credit - clearly exceed Rehab's perfected claims against the payment bonds ($158,620.04). Thus Rehab may not recover any portion of its perfected bond claims.[27]

This method of applying offsets is backwards, and misapplies the legal principle which gives a surety the benefit of all defenses and offsets of its principal. This method essentially gives the surety double the benefit of the allowed offset, and violates the basic rule of suretyship law that the liability of the principal and surety are coextensive.

3. The Judgment of the Court of Appeals Is So Plainly and Clearly Wrong, and Departs So Far From the Accepted Law, That an Exercise of this Court's Power of Supervision is Warranted.

The Court of Appeals ruling concerning Rehab's payment bond claims has no legal support whatsoever. The McGregor Act, the controlling statute, dictates a different re-

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recovery.")

26. See the discussion beginning at p. 18 for a discussion of the Texas cases involving the rule allowing a surety to utilize the defenses and offsets of the principal.

27. Appendix B, p. A-33.

sult. Rehab has been unable to locate any case law which even remotely supports the Court of Appeals decision on the payment bond issue.

The Court of Appeal's decision on the payment bond issue, if followed in subsequent cases, will effectively nullify the protection granted by the McGregor Act and other similar statutes such as the Miller Act. These laws were designed to give subcontractors and suppliers some financial protection on government construction projects. These statutes were designed to encourage subcontractors and suppliers to participate on government construction projects, and provide peace of mind that they would have a solvent source to pay their unpaid bills. The Court of Appeal's opinion reaches a non-sensical, absurd result, and is extremely poor precedent.[28] In any case where the payment bond claim is only partially perfected, unpaid subcontractors and suppliers may be left with totally uncollectible claims against insolvent customers; in other words, absolutely no protection whatsoever.

4. THE COURT OF APPEALS SHOULD HAVE SUBMITTED THE QUESTIONS CONCERNING SAFECO'S USE OF BAYTOWN'S OFFSETS, AND REHAB'S ABILITY TO RECOVER FROM SAFECO, TO THE TEXAS SUPREME COURT AS A CERTIFIED QUESTION.

The issues concerning Safeco's use of Baytown's offsets, and Rehab's ability to recover against Safeco under the facts of this case, were undoubtedly the most crucial issues involved in the appeal. All parties apparently assumed that Baytown and Safeco would be held jointly liable for the amount due on the bonded projects. Unfortunately, these issues were not even briefed to the Court of Appeals, and

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28. Pursuant to Fifth Circuit Local Rule 47.5.3, unpublished opinions are precedent, and may be cited as such in cases involving related facts.

were decided in a brief one paragraph portion of the Court of Appeal's opinion. The discussion in the Court of Appeal's opinion indicates that it did not give this crucial issue much consideration or thought.

There was a perfectly acceptable procedure that the Court of Appeals should have utilized in an attempt reach the correct result in this case. The Texas Rules of Appellate procedure contain a question certification procedure whereby important questions of state law can be sent to the Texas Supreme Court for resolution. Texas Rule of Appellate Procedure 114(a) provides as follows:

> **(a) Certification of Questions of Law.** The Supreme Court of Texas may answer questions of law certified to it by the Supreme Court of the United States or a Court of Appeals of the United States when requested by the certifying court, if there are involved in any proceeding before the certifying court questions of law of this state which may be determinative of the cause then pending and as to which it appears to the certifying court that there is no controlling precedent in the decisions of the Supreme Court of Texas. The Supreme Court may, in its discretion, decline to answer the questions certified to it.

The issues concerning Safeco's use of Baytown's offsets, as applied to the facts of this case, involve determinative questions of Texas state law on which there is no controlling precedent in the decisions of the Texas state courts. Rehab has been unable to uncover any factually similar cases decided by the Texas Supreme Court (or for that matter, any Texas appellate court), involving the application of offsets on multiple construction projects, or the application of offsets on both bonded and unbonded projects. The legal issues involved in this case easily qualify as certifiable ques-

tions under Texas Rule of Appellate Procedure 114.

The due process clause of the Fifth Amendment to the United States Constitution requires that "No person shall be...deprived of life, liberty or property, without due process of law." Rehab would submit that the Court of Appeal's failure to submit these critical legal issues to the Texas Supreme Court by means of a certified question was a violation of Rehab's right to procedural due process. It is procedurally unfair for a Court of Appeals to fail to use this certification procedure, when available under state law, to resolve novel questions of state law.

This unfairness is apparent in diversity lawsuits, such as the present case. In this diversity case, Rehab was involuntarily brought into federal court, a forum where the judges have less expertise with state law issues. The Court of Appeal's decision is plainly wrong, reaches an absurd result, and creates bad precedent. Rehab recognizes that this Court has limited resources, can only accept a limited number of cases, and can not correct every badly decided case. Accordingly, in our federal court system, a litigant's ability to correct an erroneous declaration and application of a substantive state law by a Court of Appeal's is almost non-existent. This injustice can be easily cured in those states that have a certification procedure, by imposing a requirement that the Court of Appeals submit these issues to the state court of last resort for resolution.

Policy considerations also dictate that federal Courts of Appeal, in diversity cases, should be required to certify novel questions to a state court, when the procedure is available under state law. First, state courts are more familiar with their own state law, and are in a better position to determine and develop their own common law. The procedure by which federal Courts of Appeal are required to divine (or

guess) how a state court of last resort will rule on a given issue is unpredictable and cumbersome. This guesswork is patently unfair when the relevant state law provides an easy procedure by which the issue can be sent to the state court for decision.

Second, if this requirement is imposed, any further appeal of a Court of Appeal's decision to the U.S. Supreme Court will effectively be limited to federal constitutional questions. If the state court of last resort has decided a novel question of state law as a certified question, the litigants will essentially be compelled to accept the result. Accordingly, the amount of certiorari applications made to this Court will be reduced.

Third, the work load of the various federal courts of appeal will be reduced. In cases where a state court decides a certified question involving state law, the work of the court of appeals will be reduced to the more ministerial task of entering judgment in accordance with the answer given by the state court. The federal courts of appeal will be able to devote more attention to deciding cases involving federal constitutional or statutory questions.

Finally, the guess work involved in divining state common law can be completely eliminated in situations where the state court decides the question. The large amount of bad case law issued by federal courts of appeal deciding diversity cases will be reduced.

5. THE U.S. SUPREME COURT CAN ALSO DO JUSTICE IN THIS CASE BY DIRECTLY SUBMITTING THESE IMPORTANT LEGAL QUESTIONS TO THE TEXAS SUPREME COURT AS A CERTIFIED QUESTION.

This Court can also directly utilize the Texas certified question procedure to accomplish justice in the present case, even if it feels that the use of this procedure should not be

imposed as a requirement upon the Court of Appeals. The Texas certified question procedure also allows the Supreme Court of the United States to submit questions to the Texas Supreme Court for decision. Accordingly, this court can grant certiorari for the limited purpose of certifying these questions to the Texas Supreme Court for decision. If the Texas Supreme Court answers these questions favorably to Rehab, this Court can then simply remand the entire case back the Court of Appeals with instructions to reconsider its opinion in light of the questions answered by the Texas Supreme Court. If the Texas Supreme Court answers the questions unfavorably to Rehab, or refuses to rule on the matter, this Court can then simply vacate its order granting certiorari.

The procedure outlined above would take little of this Court's time and resources, but at the same time, would do justice for the individual litigants. Essentially, the only work this Court will be required to perform will be to prepare the question for certification to the Texas Supreme Court. This procedure could be used to dispose of many of the diversity cases appealed to this Court, that may involve a bad result, but because of this Court's scarce resources, can not be fully considered on the merits.

CONCLUSION

For the reasons set forth above, Petitioner respectfully requests this Court to issue a writ of certiorari to the Court of Appeals for the Fifth Circuit, reverse the judgment of the Court of Appeals as to Respondent Safeco, and remand the case back to the Court of Appeals for further consideration.

Respectfully Submitted,

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ATTORNEY FOR PETITIONER

APPENDIX A

U.S. COURT OF APPEALS
FILED
MAY 9, 1994
CHARLES R. FULBRUDGE III
CLERK

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 93-2327

SAFECO INSURANCE COMPANY OF AMERICA,

Plaintiff-Counter Defendant,
Cross Defendant-Appellee,

versus

REHABILITATION SPECIALISTS, ET AL.,

Defendants,

REHABILITATION SPECIALISTS,

Defendant-Counter Plaintiff,
Cross Plaintiff-Cross Defendant,
Appellant,

versus

BAYTOWN CONSTRUCTION, INC., ET AL.,

Defendants-Cross Defendants,
Cross Plaintiffs-Appellees.

Appeal from the United States District Court for the
Southern District of Texas

ON PETITION FOR REHEARING
(MAY 9, 1994)

Before KING, and WIENER, Circuit Judges, and DOHERTY, District Judge.*

PER CURIAM:

IT IS ORDERED that the petitions for rehearing filed in the above entitled and numbered cause be and the same are hereby Denied.

ENTERED FOR THE COURT:

(Weiner)
United States Circuit Judge

* District Judge of the Eastern District of Louisiana, sitting by designation.

APPENDIX B

U.S. COURT OF APPEALS
FILED
APRIL 7, 1994
CHARLES R. FULBRUDGE III
CLERK

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 93-2327

SAFECO INSURANCE COMPANY OF AMERICA,

Plaintiff-Counter Defendant,
Cross Defendant-Appellee,

versus

REHABILITATION SPECIALISTS, ET AL.,

Defendants,

REHABILITATION SPECIALISTS,

Defendant-Counter Plaintiff,
Cross Plaintiff-Cross Defendant,
Appellant,

versus

BAYTOWN CONSTRUCTION, INC., ET AL.,

Defendants-Cross Defendants,
Cross Plaintiffs-Appellees.

Appeal from the United States District Court
For the Southern District of Texas
(CA-H-89-620)

Before KING, and WIENER, Circuit Judges, and DOHERTY, District Judge.*

WIENER, Circuit Judge:**

In this declaratory judgment action, Defendant/Counter Plaintiff-Appellant, Rehabilitation Specialists (Rehab), appeals the district court's take-nothing judgment in favor of Defendant/Counter Defendant-Appellee, Baytown Construction, Inc. (Baytown), and the court's award of attorneys' fees in favor of Plaintiff/Counter Defendant-Appellee, Safeco Insurance Co. (Safeco). Safeco, as surety for Baytown, issued payment bonds in favor of Rehab on four of five City of Houston (COH) projects that Baytown subcontracted to Rehab. Rehab asserted claims against Safeco on the payment bonds for the four projects and claims against Baytown on all five projects. Baytown disputed Rehab's claims and asserted backcharges that if valid would more than offset Rehab's claims.

Unable to determine whether Rehab's claims were valid, Safeco filed suit and asked for a declaration of the relative rights of the parties. Rehab sought to recover on the payment bonds from both Baytown and Safeco, and further sought breach of contract damages from Baytown. After a bench trial, Rehab was awarded nothing because Baytown's asserted backcharges were found to setoff Rehab's claims fully. Safeco, the plaintiff for declaratory judgment pur-

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* District Judge of the Eastern District of Louisiana, sitting by designation.

** Local Rule 47.5 provides: "The publication of opinions that have no precedential value and merely decide particular cases on the basis of well-settled principles of law imposes needless expense on the public and burdens on the legal profession." Pursuant to that Rule, the Court has determined that this opinion should not be published.

poses, was awarded attorney's fees of $92,046.22. Rehab, which is currently in Chapter 11, appealed.

First, we reverse and render judgment in favor of Rehab for $157,042.62 on its breach of contract counterclaim against Baytown, which is the net amount of Rehab's claims against Baytown remaining after set-off of backcharges validly allowed by the district court. Second, we affirm the district court's take nothing judgment in favor of Safeco and Baytown on Rehab's claims against the payment bonds: Rehab's perfected claims against Safeco and Baytown on the payment bonds were fully offset by valid backcharges. Third, we affirm the award of attorneys, fees to Safeco, but modify the judgment to reflect that Rehab and Baytown are jointly liable to Safeco for such fees. Finally, we affirm the district court's denial of Rehab's request for attorneys fees: As Rehab is not entitled to recover anything on the payment bonds, it is not permitted to recover attorney's fees under the McGregor Act.[1]

I
FACTS AND PROCEEDINGS

Rehab is a corporation which was involved in the rehabilitation of water and sewer lines for municipalities, and Clyde Rice was its president. Baytown and Mar-Len of Louisiana are corporations engaged in construction work, and Leonard Malinowsky is president of both companies. Safeco is an insurance company which issues payment bonds to contractors.

Rehab acted as a subcontractor for Baytown on several

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1. Tex. Rev. Civ. Stat. Ann. arts. 5160-5164 (Vernon 1987 & Supp. 1994), repealed in part by Acts 1993, 73rd Leg., ch. 268, §46(1) (codified as amended at TEX. GOV'T CODE ANN. §2253 (Vernon Supp. 1994)).

projects, including the following[2]:

Project	Start Date	Form	Description
4038-1	1/84	Written	"Closed" project[3]
3981-1	1/85	Oral	Time and materials contract[4]
Bacliff MUD	1/86	Written	"Closed" project
4040-1	2/86	Written	"Closed" project
3783-2 ("-2")	9/86	Written	Payment bond by Safeco
3783-7 ("-7")	11/86	Written	Payment bond by Safeco
3783-8 ("-8")	12/86	Written	Payment bond by Safeco
3783-9 ("-9")	1/87	Written	Payment bond by Safeco
4020-1	10/87	Written	No payment bond

Rehab usually performed 100% of the work required by each general contract awarded to Baytown. Baytown's commission was 12% of the amount of the general contract with the owner. Stated another way, Rehab was to be paid 88% of the general contract amount ("the subcontract amount").

Generally, during the course of construction Baytown would cover Rehab's current expenses that it would otherwise have had to pay out of the subcontract amount, i.e., its 88% of the general contract amount. Baytown did this because Rehab lacked the financial capability to meet these expense payments as they came due during the course of a project. The expenses in question were the payroll for

2. The parties' relationship began as early as 1983, but the record is devoid of evidence concerning projects subcontracted by Baytown to Rehab prior to 1984.

3. A project was closed between the owner and the general contractor after the work was fully and satisfactorily completed and Baytown had received the full amount due under each general contract.

4. On such a project, Rehab would be reimbursed for whatever it spent.

Rehab's employees, payroll burden (payroll taxes and contributions), equipment rental charges, and materials. Baytown also made working capital advances and partial payments to Rehab from time to time, depending on the amount of work completed to date on each project. For accounting purposes, these payments were deducted on a monthly basis from the 88% due to Rehab, an accounting practice that was reflected on separate "Subcontract Payment Estimates" issued monthly by Baytown to Rehab for each project.

To obtain such payments periodically for its work in progress,, Rehab would prepare a partial completion estimate for each project and submit such estimates to the owners. The owners would verify Rehab's estimate, then prepare and submit to Baytown an owner's "Payment Estimate" for each project, setting forth the percentage of work that the owners believed had been completed. From the owners' Payment Estimates, Baytown would then prepare "Subcontract Payment Estimates" (estimate) for the projects. Based on such estimates, Rehab would receive payments from Baytown each month. The estimates stated the subcontract amount and calculated the payment due Rehab by deducting from the subcontract amount (1) previous payments made by Baytown to third parties for expenses incurred by Rehab (such as payroll), (2) previous partial completion payments to Rehab, and (3) advances to Rehab for working capital.

After the work on a project was complete and that project was "closed" between Baytown and the owner, Baytown would furnish Rehab a "Final Subcontract Payment Estimate" (final estimate) setting forth the final subcontract amount,[5] deductions, and the amount due Rehab. On each

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5. The initial subcontract amount, which appeared on the written subcontracts, was subject to change for additional work authorized by change orders.

closed project, the last Subcontract Payment Estimate issued by Baytown was denominated the "final" estimate. Rehab considered each of the written subcontracts to be an independent agreement, which came to closure when the work on that project was completed and "final payment" was made. As a result, Rehab believed that the accounting between it and Baytown for each "closed" project was at an end.

Baytown, on the other hand, maintains that the parties had only one - in "large part " oral - contract, which Baytown asserts was formed by "a course of dealing" between Baytown and Rehab. As for the fact that all but one of the projects begun during or since 1984 were reduced to writing, Baytown explains that the written subcontracts, although pertaining to particular projects, were merely components of the single "course of dealing" contract encompassing all projects between Rehab and Baytown. Baytown insists that its relationship with Rehab was "a continuing open account, " under which Baytown constantly propped up Rehab by making monthly advances and payments thus keeping Rehab in business while projects were ongoing.

Baytown asserts that in the aggregate its payments and advances to or on behalf of Rehab exceeded the amount that Rehab was entitled to be paid, and that the parties always intended to "settle up" at some point in the future.[6] Baytown also asserts that it had never "closed out" a project with Rehab over the course of their five-year business relationship. It explains that "final,, in its "Final Subcontract Payment Estimates" to Rehab meant finality vis-a-vis the

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6. According to Baytown's representations to the district court, Rehab had been overpaid more than $1.25 million over the course of the parties' relationship.

owner; and Baytown represents to us that "final estimates" were only estimates of finality.[7]

During 1986 and 1987, Baytown entered five general contract with COH (the COH projects) to wit: projects -2, -7, -8, -9, and 4020-1. All work on each of those projects was subcontracted to Rehab. Safeco furnished payment bonds to Baytown on four of the COH projects: -2, -7, -8, and -9 (the bonded projects). The payment bonds were issued pursuant to the McGregor Act. Baytown and others agreed to indemnify Safeco against losses it might suffer as a result of issuing the bonds.

Rehab characterizes the relationship between itself and Baytown before the start of the COH projects in September 1986 as "pleasant, excellent." That relationship deteriorated, however: A $12 million wrongful death action was filed against Baytown and Rehab after a trench accident occurred on project -2 that resulted in the deaths of Bud Simien, a subcontractor to Rehab, and his brother. Also, an OSHA citation was issued to Baytown. It asserts that the OSHA citation should have been issued to Rehab, and blames Rehab for the "wrongful" issuance of the citation. That citation, though later withdrawn after Baytown protested its issuance, apparently caused Baytown temporarily to lose its bonding capability late in 1986 or early in 1987. Then, late in 1987, Rehab successfully bid two COH projects (1783-29 and 1783-30) on its own, without Baytown's involvement. This spelled the death knell of Baytown's commissions on any projects performed by Rehab.

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7. The district court implicitly found for Baytown on this issue: it allowed offsets for overhead on 4038-1, 4040-1 and Bacliff MUD, projects that Rehab had asserted were already closed.

After Baytown refused to pay Rehab for the five COH projects, Rehab filed claims against Safeco on the bonded projects. Baytown, as principal on the bonds, disputed Rehab's bond claims and alleged backcharges that if valid would fully offset Rehab's bond claims - and demonstrate that Baytown had overpaid Rehab. As surety on the bonds, Safeco was entitled to assert all offsets alleged by its principal, Baytown.[8] As noted, Safeco filed the instant suit[9] seeking a declaration of the relative rights of the parties and questioning whether Rehab's bond claims were valid. Rehab counterclaimed for payment of the bond claims. The parties stipulated that under the McGregor Act Rehab had perfected $158,620.04 of its claims against the payment bonds.

Rehab also filed a cross-action against Baytown,[10] seeking $336,743.95 under the written subcontracts on the five COH projects and $75,000 under the oral subcontract (3981-1).[11] Baytown cross-claimed against Rehab to recover its "overpayments" on many projects (not just the six projects for which Rehab asserted claims), which overpayments, if proved in full, would not just have offset Rehab's claims but would have entitled Baytown to a positive recovery as well. Baytown asserted backcharges for projects that Rehab believed had been closed between itself and Baytown (4038-1, 4040-1, and Bacliff MUD) for all purposes-and especially

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8. Aultman & Taylor Co. v. Hefner, 67 Tex. 54, 62, 2 S.W. 861, 864 (Tex. 1886); Robberson Steel, Inc. v. J. D. Abrams, Inc., 582 S.W.2d 558, 564-65 (Tex. Civ. App. - El Paso 1979, no writ).

9. Baytown defended Rehab's claims against the payment bonds pursuant to its agreement to indemnify SafeCo.

10. Rehab also filed a cross-action against Mar-Len of Louisiana, but these claims were dismissed and are not relevant to this appeal.

11. The $75,000 oral contract claim appears to have been abandoned.

for accounting purposes. Baytown also asserted backcharges for categories of payments that had never before been reflected on the estimates from Baytown to Rehab: overhead, claims costs,[12] and payments made on claims by second tier subcontractors (Rehab's subs).[13] The total backcharges asserted by Baytown exceeded $1.25 million. Rehab filed for bankruptcy protection under Chapter 11 and the bankruptcy court stayed the cross-action.

The bench trial ended with Rehab being awarded nothing. Issues of credibility were resolved in favor of Baytown and thus against Rehab. The principal issues involved in this appeal turn on Finding 10, which lists "the payments, credits, offsets and/or backcharges that Baytown is entitled to assert against Rehab as a result of the course of dealing between them":

> 10. Defendant Baytown is entitled to assert the following payments, credits, offsets and/or backcharges against Defendant Rehab on the following projects as a result of the course of dealing which existed between Defendant Baytown and Defendant Rehab, and Defendant Rehab is not entitled to any affirmative recovery on same (except as to Project 3783-9 to the extent of $22,236.94).
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> | | |
> |---|---|
> | Project 3783-2 | $48,861.87 |
> | Project 3783-7 | 60,849.67 |

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12. Baytown asserts that it is entitled to deduct its costs of defending claims brought against it for the death of the Simien brothers on project -2.

13. At least three of Rehab's subcontractors apparently asserted that Rehab had not paid their claims. Baytown paid Rehab's subs and now asserts that the subcontracts require Rehab to reimburse Baytown for those payments.

Project 3783-8	25,505.23
Project 4020-1	25,482.20
Project 4038-1	108,846.11
Project 4040-1	98,878.04
Bacliff MUD	22,838-95
Project 3981-1	102,386.07

> Defendant Baytown is not entitled to assert any credits or offsets on Projects 1783-29, 1783-30, or on Maco [Rehab's subcontractor] against Defendant Rehab.

Rehab moved to amend the findings to clarify how Finding 10 was calculated. That motion was denied. Safeco, the plaintiff in the declaratory judgment action, was awarded attorney's fees of $92,046.22. Rehab appeals.

The en globo nature of Finding 10 does little to assist our analysis. Our examination of the record and our reconstruction of the district court's calculations reveal that the district court found that Baytown had in fact overpaid Rehab in the aggregate amount of $471,411.20 for all of the subcontracts.[14] The district court arrived at that sum by making a series of calculations. First, the court determined the individual subcontract amounts and deducted therefrom undis-

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14. Baytown and the district court believed that Finding 10 ($471,411.20) offset Rehab's claims ($336,743.95) and - if the cross-action had not been stayed - Baytown would have been entitled to an affirmative recovery of $134,667.25. But in fact, Finding 10 actually represents the amount that Baytown paid over and above the sum of all subcontract amounts ($471,411.20) - hence Finding 10 would be Baytown's "claims" against Rehab. The claims asserted by Rehab are the $336,743.95 below the sum of all subcontract amounts that it was supposed to have been paid- the actual "offsets." In sum, Rehab argues that it was "underpaid" $336,743.95; Finding 10 reflects that the court (albeit possibly through inadvertence) found that Rehab was overpaid the full amount of $471,411.20 on eight subcontracts.

puted charges and payments (advances, payroll, payroll taxes, materials, and equipment charges). Second, the court deducted the following disputed offsets: (1) $37,774.19 for Baytown's overpayment on a "closed project" (4038-1); and (2) $102,386.07 for Baytown's overpayment on project 3981-1, the incomplete time and materials contract (a total of $140,160.26). Third, the court deducted all backcharges requested by Baytown for (1) overhead, $476,469.76; (2) claims costs, $59,154.94; and (3) 98% of claims by Rehab's subs, $51,126.54.[15] As a result, the disputed offsets allowed by the court totalled $726,911.50. The court's calculations produced a bottom-line figure for each project (Finding 10) - all but one of which reflected an "overpayment" by Baytown to Rehab. The sum of these "overpayments" - $471,411.20 - is thus the amount that Rehab must defeat on appeal before it may begin to recover anything on its claims.

Rehab questions (1) whether proper interpretation of the subcontracts would permit Baytown to deduct overhead, claims costs, and claims by Rehab's subs; and (2) whether the amount of the offsets allowed for the two latter categories is accurate. Thus, of the $726,911.50 in disputed offsets that were allowed by the district court, Rehab on appeal challenges only $586,751.24 (the total amount of backcharges allowed as set-off for overhead, claims costs, and claims by Rehab's subs). Rehab apparently accepts the court's allow-

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15. Approximately 43% of offsets claimed by Baytown were not allowed by the court-a total of $541,055.71. That figure includes 2% of the backcharges claimed by Baytown for its "payments" to Sugarland, Manholes, and ADS ($1,073.39), and 100% of backcharges claimed by Baytown for its "payments" to Rehao's subs MACO ($533,271,84) and Simien ($6,710.48). The court disallowed these claimed offsets because they were never paid by Baytown. Baytown does not assert on appeal that disallowed offsets should have been allowed.

ance of $140,160.26 of the offsets disputed at trial.[16] That conclusion reduces the maximum amount that Rehab may recover to $196,583.69 ($336,743.95 minus $140,160.26).

II
ANALYSIS[17]

A. Standard of Review

Fact findings may be set aside if they are clearly erroneous.[18] The offsets listed in Finding 10 are essentially contract damages that Baytown would be entitled to recover from Rehab if Rehab were not bankrupt and if Rehab could not prove its claims. "Damages need not be proven with an exact degree of specificity, and we review the award under the clearly erroneous standard."[19] Questions of law,[20] or mixed questions of law and fact, are reviewed de novo.[21]

B. Discussion

1. Stipulations Ignored?

Finding 10 informs us that the net amount of Baytown's overpayment to Rehab is $471,411.20. Rehab contends that in calculating the offsets in Finding 10, the district court

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16. Except for overhead charges, Rehab does not challenge on appeal those offsets awarded to Baytown on 4038-1 ($37,774.19) and 3981-1 ($102,386.07).

17. Texas substantive law governs this diversity case.

18. FED. R. CIV. P. 52(a).

19. Albany Ins. Co. v. Bengal Marine, Inc., 857 F.2d 250, 253 (5th Cir. 1988).

20. Seal v. Knorpp, 957 F.2d 1230, 1234 (5th Cir. 1992).

21. United States for Use of Consol. Elec. Distr., Inc. v. Altech, Inc., 929 F.2d 1089, 1092 (5th Cir. 1991).

erroneously relied on the subcontract amounts listed in Exhibit 11,[22] a document that was never admitted into evidence - rather than those in Exhibits 2 (Rehab's summary sheet) and 3 (Baytown's summary sheet), which were stipulated to by the parties. The first issue, then, is whether the court erred in using subcontract amounts from Exhibit 11 to calculate Finding 10 rather than using figures stipulated to by the parties.

Rehab makes two basic arguments with respect to the "stipulations." First, it claims that the parties stipulated to the subcontract amounts due to Rehab on the COH projects before deduction of backcharges; and that these stipulations were binding on - but were ignored by - the court. Second, Rehab insists that even if the stipulations were not binding on the court, it erred in calculating Finding 10 when it used subcontract amounts from Exhibit 11. As Exhibit 11 was never formally admitted into evidence- and as the record does not support Exhibit 11's subcontract amounts - the amount of offsets in Finding 10 are erroneous, says Rehab, to the tune of $81,243.66 (the difference between the sum of the subcontract amounts on Exhibit 11 and the sum of those agreed upon by Baytown and Rehab).

Under Texas law, stipulations of fact may bind a court if the stipulations comply with Rule 11 of the Texas Rules of Civil Procedure relating to written agreements between attorneys or parties.[23] And federal courts sitting in diversity

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22. Exhibit 11 was prepared by Baytown at the request of the trial court and was based primarily on the last payment estimates issued by Baytown to Rehab for each project.

23. Gulf Construction Co. v. Self, 676 S.W.2d 624, 630 (Tex. App. - Corpus Christi 1984, writ ref'd n.r.e.).

are required to apply this state rule.[24] The record clearly reflects that Baytown and Rehab stipulated in the presence of the court that the relevant subcontract amounts were those appearing on Exhibits 2 and 3. The agreement complies with the "made-in-open-court" exception to Rule 11's requirement of a writing[25] and is not contrary to any purported subcontract amounts disclosed by the record.[26] Although setting aside or modifying a stipulation is apparently within the discretion of the trial court,[27] it does not appear from the record that the district court attempted to modify or set aside the stipulation made between the parties. Instead, the district court appears to have inadvertently disregarded the stipulated subcontract amounts. The subject stipulations thus bind the court as well as the parties in this case.

Although Baytown concedes that it stipulated to the dollar amounts of certain subcontracts, it argues that any error is harmless, as offsets calculated with only Exhibit 3 figures still exceed Rehab's claims. We disagree. Such error is not harmless; it directly affects this appeal and its outcome.

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24. Anderegg v. High Standard, Inc., 825 F.2d 77, 80 (5th Cir. 1987) ("We have held that Rule 11, although to be found among the Texas Rules of Civil Procedure, is nonetheless also a rule of substance akin to the parol evidence rule and applicable for that reason to Texas diversity cases tried in our federal court system.") (citing Condit Chem. & Grain Co. v. Helena Chem. Corp., 789 F.2d 1101 (5th Cir. 1986)), cert. denied, 484 U.S. 1073, 108 S. Ct. 1046, 98 L. Ed. 2d 1009 (1988).

25. Id., 825 F.2d at 81.

26. Cf. Penick v. Penick, 750 S.W.2d 247, 249 (Tex. App. - Houston [14th Dist.] 1988), rev'd on other grounds, 783 S.W.2d 194 (Tex. 1988); Gulf Constr., 676 S.W.2d at 630.

27. Cf. Penick, 750 S.W.2d at 249 (citations omitted).

The offsets allowed by the court in Finding 10 were artificially increased by $81,243.66 through the use of subcontract amounts from Exhibit 11. This in turn increased the amount of offsets that on appeal Rehab must demonstrate to be erroneous before it is entitled to recover any part of its $336,743.95 in claims. In other words, when Exhibit 11 subcontract amounts are used to calculate Finding 10, Rehab has to demonstrate $471,411.20 in erroneous offsets before it starts to recover anything, whereas when the stipulated subcontract amounts are used, Rehab need only demonstrate $390,167.54 in erroneous offsets.

Thus Finding 10 is clearly erroneous to the extent that the subcontract amounts used by the court differed from those stipulated by the parties - an error detrimental to Rehab in the amount of $81,243.66. At most, then, Rehab need only prove an additional $390,167.54 in erroneous offsets - not $471,411.20 - before it may begin to recover any portion of its claims.

2. Offsets for Overhead

a. Construction of Subcontracts

Rehab asserts that the court erroneously allowed the requested backcharge for overhead ($476,469.76) on eight projects (-2, -7, -8, -91 4020-11 4038-1, 4040-1, and Bacliff MUD). At trial, the only justification advanced by Baytown for the overhead backcharge was the subcontract term "etc." (et cetera). Thus whether offset for overhead was properly allowed depends on the interpretation of the written subcontracts - a legal question that is subject to de novo review.

1. Projects -2, -8, and -9: Does "etc." include overhead?

In fact, only three of the written subcontracts, those for projects -2, -8, and -9, contain the word "etc." To determine

what deductions are authorized by the subcontract term "etc.," we take the wording of the subcontracts, examine that wording in light of the circumstances, apply the pertinent rules of construction, and thereby find the meaning of the subcontracts.[28] Articles 3(A) of the subcontracts for projects -2, -8, and -9 (with only minor differences in project -2) provide that

> [t]he Contractor shall pay the Subcontractor in current funds for the performance of the work, subject to additions and deductions by Change Order, the total sum of __(specified amount)__ . LESS payroll, taxes, etc. paid for by Baytown Construction Co., Inc.[29]

Clearly our attention must focus on the phrase, "LESS payroll, taxes, etc. paid for by Baytown." The historical circumstances reflect that the only deductions ever taken by Baytown on its monthly and final payment estimates were deductions for Rehab's payroll, payroll taxes, materials, and equipment rental. Baytown's own overhead was never mentioned.[30]

First, we consider the plain grammatical meaning of "etc."[31] Both its literal translation from the Latin et cetera and its universally accepted English usages and meanings are "and others," "and other things," and "others of like kind

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28. Aetna Life & Casualty Co. v. Gunn, 628 S.W.2d 758, 760 (Tex. 1982).

29. Emphasis added.

30. Even Baytown concedes that the one time that it did attempt to deduct overhead, on project 3981-1, the deduction was admittedly improper (albeit not for the same reason that we conclude it was improper).

31. Reilly v. Rangers Mgt., Inc., 727 S.W.2d 527, 529 (Tex. 1987).

or character."[32] Thus etc. is not open-ended or unlimited in reach; it is limited by the specific examples in the list that it modifies. The phrase immediately following the word etc. - "paid for by Baytown" - further restricts the class of items anticipated by the term etc.

Read in context of the full contractual provision, the experience of the parties, and the universally accepted meaning of etc., the authorized deductions are: payroll, taxes, and other items of like kind or character paid for by Baytown. Thus there remains to be answered only the sub-question, "Which putative deductions are 'others of like kind' and which are not?"

We answer that inquiry by applying the venerable maxim of ejusdem generis. "[E]jusdem generis applies when words of a specific and particular meaning are followed by general words and when an ambiguity exists.[33] A general word that follows a list of specific items is held to refer to the same class of items as the items that are specifically mentioned.[34] We thus construe general words that follow specific words to include only the class or category framed by the specific words.[35]

We observe first that Baytown's overhead is not "paid for" by Baytown in the same sense that Rehab's payroll, payroll taxes, materials, and equipment rental are "paid for" by

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32. BLACK'S LAW DICTIONARY 553 (6th ed. 1990).

33. Corpus Christi v. Bayfront Assocs., Ltd., 814 S.W.2d 98, 104 (Tex. App. - Corpus Christi 1991, writ denied).

34. Haney v. Minnesota Mut. Life Ins. Co., 505 S.W.2d 325, 328 (Tex. Civ. App. - Houston [14th Dist.] 1974, writ ref'd n.r.e.).

35. Stanford v. Butler, 142 Tex. 692, 698, 181 S.W.2d 269, 272 (Tex. 1944).

Baytown. Those items are specific expenses incurred by the non-paying party - here, Rehab - but disbursed as an accommodation by the paying party - here, Baytown. By contrast, the paying party's own overhead is directly incurred by it as one of its own costs of doing business. Overhead is not an expense of doing business of Rehab that is paid for, i.e., disbursed by, Baytown, in the sense that those of Rehab's anticipated costs - expressly listed in the subcontracts and preceding the word "etc." - are disbursed by Baytown.

Next, we look to the way the parties to agreements, by their actions, have interpreted their agreements: Here, Baytown's historical failure ever to attempt to charge Rehab for Baytown's own overhead at any time during the entire course of the parties, long business relationship confirms the conclusion that Baytown's overhead is not the kind of cost paid for by Baytown that would be caught in the net of ejusdem generis. As Baytown's overhead is not part of the class or category of items that includes payroll or payroll taxes or materials or equipment rental paid for by Baytown, such overhead is not encompassed in the term etc.

Clearly, then, Baytown was not entitled to an offset of $153,702.70 for its overhead related to projects -2, -8, and -9[36]

2. Projects -7 and 4020-1

The subcontract for project -7 does not contain the word etc., Baytown's sole asserted contractual justification for the deduction of overhead. Project -7's subcontract was executed within the same two-week period that the subcontracts for projects -2 and -8 were executed, and reads in pertinent

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36. Baytown claimed overhead for those projects in the following amounts: project -2, $61,889.15; project -8, $31,197.93; and project -9, $60,615.62.

part, "less payroll, taxes, paid for by [Baytown]." Construing the plain wording of this subcontract as written, we conclude that project -7 does not authorize Baytown's deduction of overhead for that project in the amount of $101,608.12. Absent etc. or any other words of generality, "payroll, taxes" constitutes an exclusive two-item list of deductions authorized under that contract.

Neither does project 4020-1 contain "etc." It reads "less payroll, payroll taxes, materials, and any unpaid bills produced by [Rehab] to perform this contract." Clearly the final item in the otherwise exclusive list of permitted deductions could not be stretched to include Baytown's overhead. This subcontract was the final COH subcontract executed between the parties, and further confirms our earlier conclusion that the parties never intended for overhead to be deducted under any of these subcontracts. This last subcontract appears to have clarified the term et cetera - and it still cannot be stretched to include overhead. Baytown's $28,370.03 in overhead on project 4020-1 simply cannot be "shoehorned" into any of the specific categories listed as authorized deductions: "payroll, payroll taxes, materials, and any unpaid bills produced by [Rehab] to perform this contract."

As the subcontracts for neither project -7 nor project 4020-1 authorize Baytown to deduct its overhead, the district court was in error when it allowed overhead offsets for these two projects in the amount of $129,978.15.[37]

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37. The court had allowed an overhead offset for project -7 in the amount of $101,608.12 and for project 4020-1 in the amount of $28,370.03.

3. Projects 4038-1, 4040-1 and Bacliff MUD.

Rehab never claimed any amounts due for projects 4038-1, 40402, or Bacliff MUD, yet Baytown was allowed an offset of $230,563.10 for its "overpayments" to Rehab for these projects. The vast majority of those asserted overpayments ($192,788.91) comprise late-in-the-game "afterthought" assertions of backcharges for overhead. These subcontracts - all written - were not even introduced into evidence. The only record support for the overhead numbers for these projects is Baytown's summary sheet, Exhibit 3.[38] We conclude that the district court erred in allowing overhead offset for these three projects in the amount of $192,788.91.[39]

In conclusion, we agree with Rehab that the district court erred as a matter of law when it allowed Baytown's total requested backcharge for overhead ($476,469.76) on all eight projects (-2, 7, -8, -9, 4020-1, 4038-1, 4040-1, and Bacliff MUD). Accordingly, at this interim juncture - even before we address the offsets for claims costs and claims of Rehab's subs - Rehab would be entitled to a judgment in its favor in the amount of $86,302.22.[40]

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38. Although it introduced job costs reports for the COH projects to support the overhead figures on its summary sheets, Baytown did not introduce job cost reports for projects 4038-1, 4040-1, and Bacliff MUD.

39. The court allowed Baytown overhead offsets for these projects in the following amounts: 4038-1, $71,071.92; 4040-1, $98,878.04; and Bacliff MUD, $22,838.95.

40. Recall that after correction for the stipulated subcontract amounts, Finding 10's offsets (Baytown's affirmative "claims") totalled $390,167.54. As the subcontracts did not authorize any of the offsets for overhead that were allowed by the court ($476,469.76), Baytown's affirmative "claims" of $390,167.54 and an additional $86,302.22 in actual offsets against Rehab's claims evaporate.

b. Course of Dealing

Baytown does not disagree with the rules of contract construction applied above. Instead it argues that these rules do not apply in this case because the district court found that the course of dealing between the parties, which Baytown argues was "the contract," reflects that the parties intended to deduct overhead.[41] We disagree.

First, Baytown's sole justification offered at trial for the deduction of overhead was the subcontract term, "etc." It did not rely on the course of dealing to demonstrate that overhead was to be deducted. Second, even if at trial Baytown had relied on the course of dealing to demonstrate that Rehab would pay Baytown's overhead, our analysis of that course of dealing compels us to reach exactly the opposite conclusion. As noted, the "course of dealing" includes Baytown's accounting and billing practices over several years, which reflects that Baytown never once claimed deductions for overhead.

Baytown's course of dealing argument would turn the concept on its head. A course of dealing generally supplies terms for ambiguous, silent, or incomplete contracts; yet here, Baytown asserts that the course of dealing <u>is</u> the contract, supplanting the written agreements acknowledged by the parties. In reality Baytown would have us ignore the terms of the written subcontracts - eight of nine of the subcontracts at issue - in favor of some overarching, vaguely omnipresent course of dealing between the parties, a "course

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41. The court also allowed deductions for claims costs and claims of Rehab's subs under the "course of dealing," but Baytown does not pretend that deductions for those items turn on anything other than construction of the subcontracts.

of dealing" which does not even support Baytown's argument that it is entitled to deduct overhead.

While it is at least conceivable that the parties may have intended to switch roles in responsibility for Baytown's overhead on these projects - if, for example, Baytown's commission were reduced from 20%, with Baytown paying its own overhead, to 12%, with Rehab paying that overhead - such an implied agreement to "switch" is at most supported only by the self-serving testimony of Baytown's president, Mr. Malinowsky, and its controller, Mr. Boudreaux. In fact, even though one of those two witnesses stated that overhead was deducted from Baytown's 20% commission, he described the 20% as a "clear profit with only minor expenses deducted.[42] In an apparent contradiction of logic, Baytown's witnesses also describe the 12% as "clear profit" but assert that overhead was not to come out of that amount. None of the subcontracts describe Baytown's 12% fee as "clear profit." Mr. Rice, the president of Rehab, approached Malinowsky about reducing the commission to Baytown from 20% because it was a little steep under the circumstances - after all, Rehab was performing 100% of the work! The record reflects that Malinowsky, not Rice, suggested the 12% figure. This does not portray an agreement between the parties to shift responsibility for Baytown's overhead to Rehab - it would be pointless for Rehab to ask Baytown to lower its commission if the net effect would be the same, leaving Rehab no better off despite Baytown's agreeing to lower its commission.[43]

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42. Emphasis added.

43. Overhead for the COH projects, project 4038-1, project 40401, and project Badiff MUD comprised approximately 7.2% of the general contract amounts for those projects.

The best evidence of the parties, intent is the interpretation given by their actions (or inaction).[44] Although it knew the cost that it was incurring for overhead,[45] Baytown's conduct - its failure to assert overhead on its estimates, and its failure to assert the backcharge until litigation had been underway for over a year - indicates that the parties never agreed that Rehab would absorb Baytown's overhead.

3. "Claims Costs"

The district court also allowed Baytown to offset Rehab's claims with "claims costs" of $59,154.94. The "claims costs" asserted by Baytown as offsets relate not to claims made by Baytown against the owner or third parties on Rehab's behalf, but to the defense of claims brought against Baytown by third parties. Rehab contends that nothing contained in the subcontracts authorizes the deduction of claims costs of the type asserted by Baytown late in the day. Alternatively, Rehab argues that any amounts of offsets for claims costs in excess of $32,500 would be clearly erroneous: offsets for claims costs over that amount - the rum actually expended by Baytown - represent purely speculative, projected or future claims costs and should not have been allowed.

Rehab insists that Baytown is improperly attempting to deduct claims costs incurred in defending claims against Baytown, specifically, the OSHA citation on project -2. As deduction of claims costs also turns on construction of the written subcontracts, we review this issue de novo.

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44. See Lone Star Gas Co. v. X-Ray Gas Co., 139 Tex. 546, 552, 164 S.W.2d 504, 508 (Tex. 1942).

45. The record contains job cost reports dated July 1987 and June 1988 that detail Baytown's overhead costs for the COH projects.

Article 10(E)(4) of each of the subcontracts with COH provides:

> Subcontractor is responsible for any and all costs incurred by Contractor of claim preparation and documentation for Subcontractor's portion of work and will reimburse Contractor for documentation, preparation, computation, negotiation, consulting and/or accounting and attorney fees costs of arbitration, mediation or litigation, prorated overhead and travel time.

The paragraph that immediately precedes Article 10(E)(4), Article 10(E)(3), which Baytown would like this court to ignore, reads

> Subcontractor shall make all claims to the Contractor in the manner provided in the Contract Documents for like claims by the Contractor upon the Owner, except that the time for making claims for extra costs shall be one (1) week.

Rehab insists that the parties intended to require Rehab to bear only those claims costs incurred by Baytown in asserting claims on Rehab's behalf against either the owner or a third party with respect to Rehab's work. Instead, all of the claims costs incurred by Baytown for which it seeks set-off relate to the defense of claims brought by third parties against Baytown. Witnesses for Baytown testified that no claims costs incurred by Baytown related to either of the two types acknowledged by Rehab as proper under the subcontracts: (1) claims of Rehab against the owner, or (2) claims of Rehab against a third party. Thus, Rehab insists, Baytown has incurred no "claims costs" that may properly be deducted under the subcontracts.

Not surprisingly, Baytown argues that nothing in the subcontracts limits the type of claims costs that Baytown is al-

lowed to deduct. When we read the agreements in context, however, we agree with Rehab as a matter of law.

In effect, Baytown is attempting to turn Article 10(E)(4) into an indemnification provision for attorney's fees. But when we read Article 10(E)(4) in pari materia with the preceding article, 10(E)(3), we are compelled to agree with Rehab's position that it is required - unambiguously - to reimburse Baytown only for any costs it may incur in preparing claims on Rehab's behalf against the owner or third parties, but no others. Consequently, the offsets for claims costs - a total of $59,154.94 on the five COH projects - should not have been allowed.

Up to this point we have concluded that the district court erred in allowing offsets for overhead ($476,469.76) and claims costs ($59,154.94). At this juncture, then, Rehab would be entitled to a favorable judgment in the amount of $145,457.16. Still, one category of offsets allowed by the court remains to be addressed: claims against Rehab by its subs.

4. Claims by Rehab's Subcontractors

The district court concluded that Baytown was entitled to offset Rehab's claims by $51,126.54 for payments made by Baytown to Rehab's subs.[46] Rehab challenges the court's conclusion by arguing that (1) the subcontracts do not authorize Baytown to deduct its payments to Rehab's subs for their claims against Rehab unless those claims are first perfected against the payment bonds; and (2) even assuming that Baytown may charge Rehab for its payments to Rehab's subs without first requiring subcontractors to perfect bond

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46. Again, the district court allowed Baytown to charge Rehab for 98% of its claimed payments to ADS ($11,727.46), Manholes, Inc. ($3,412.75), and Sugarland ($35,976.33).

claims, Baytown cannot be allowed an offset in excess of amounts actually paid to Rehab's subs.

a. Construction of the Subcontracts

Article 10(C) is the only provision of the subcontracts between Baytown and Rehab that relates to claims asserted by Rehab's subs, and states in pertinent part:

> C. Subcontractor agrees to turn said work over to Contractor in good condition and free and clear from all claims, encumbrances and liens for labor, services, or materials, and to protect and save harmless Contractor and Owner from all claims encumbrances and liens growing out of the performance of this work and all maintenance required under the Contract Documents, and should Subcontractor, during the progress of said work, or at any time thereafter, fail to pay for all labor, services and materials used, purchased for use in the prosecution of said work, Contractor may, at its option and without notice to Subcontractor, pay all such claims and charge the amounts thereof to Subcontractor.[47]

Rehab urges that Baytown must prove[48] that (1) a claim was asserted against Baytown, Safeco, or COH, and (2) the claim was "valid." Rehab maintains that, as the projects were governed by the McGregor Act, the exclusive method by which Rehab's subcontractors could validly assert a claim against Baytown, Safeco, or the COH was by perfecting a claim against the payment bonds posted by Baytown. In effect,

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47. Emphasis added.

48. It is Baytown's burden to prove offsets to which it is entitled. Atkins v. Williamson, 320 S.W.2d 425, 427 (Tex. Civ. App. - Austin 1959, writ dism'd).

Rehab argues that the only "valid claim" in the setting of the McGregor Act is one properly perfected against a payment bond. To perfect a McGregor Act claim, the subcontractor would be required to send statutorily prescribed notices to the general contractor and its surety within the time periods specified in the statute. Without perfected payment bond claims for the unpaid bills of Rehab's subcontractors, insists Rehab, neither Baytown nor Safeco nor the COH could be exposed to any liability to the second tier subs.

Rehab also insists that the record is devoid of evidence of any sort of claim against Rehab by its subs, much less evidence of a validly asserted bond claim, so that any offset for sums paid on unperfected or invalid claims to Rehab's subcontractors was improper. We disagree with Rehab's characterization of the record: The checks made payable to Rehab's subs and the accompanying letters are "some" record evidence that claims were made. We do agree, however, that the record is devoid of evidence of any valid bond claim.

But Baytown insists that the subcontracts do not require perfection of a bond claim by Rehab's subcontractors as a prerequisite to Baytown's right to recognize a "valid" claim and pay it. Baytown argues that it should not be required to wait for a claim against the bonds or for the filing of a lawsuit before it pays an otherwise "valid" claim.

The Texas Supreme Court[49] has recognized that even if payment bonds expressly limit recovery for suppliers, claims

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49. When confronted with a similar situation that presented the question of liability on a payment bond governed by the McGregor Act, that court avoided the question. See Miner-Dederick Constr. Corp. v. Mid-County Rental Svc., Inc., 603 S.W.2d 193, 199 (Tex. 1980), reversing 583 S.W.2d 428.(Tex. Civ. App. - Beaumont 1979).

to those established in compliance with the McGregor Act, a subcontractor may-by an indemnity agreement that does not require perfection of claims - give up its right to insist that claims be perfected against the payment bonds.[50] Article 10(C) of the subcontracts at issue here, which specifically addresses the claims of Rehab's subs, does not expressly limit Baytown's indemnity rights to claims perfected under the McGregor Act. We conclude that Article 10(C) of the subcontracts does not require perfection of claims against the bonds, and we are unwilling to infer any such requirement.[51] Therefore, Baytown is not precluded from being indemnified by Rehab through offset for the payments Baytown actually made to Rehab's subcontractors.[52]

b. Amount of Offset Allowed: Clearly Erroneous

Although we thus conclude that Baytown is allowed to pay claims by Rehab's subs and recover the amount of such payments from Rehab by way of offset, we also conclude that Baytown should be able to charge Rehab only for the amounts actually paid by Baytown to Rehab's subs. Careful review of the record reveals that the district court, too, intended to allow offsets only for payments actually made by Baytown to Rehab's subs.[53]

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50. Miner-Dederick, 603 S.W.2d at 199.

51. See Fontenot v. Mesa Petroleum Co., 791 F.2d 1207, 1221 (5th Cir. 1986) (holding that notice requirement will not be inferred from an indemnity agreement that does not expressly require notice).

52. The Texas Supreme Court noted that "[t]o hold otherwise would allow a subcontractor to avoid the ultimate responsibility for debts owed to its suppliers on the basis of a statutory notice provision enacted for the general contractor's protection." Miner-Dederick, 603 S.W.2d at 200.

53. As Baytown attempted to recover 100% of claims by Rehab's subs,

The sole documentary evidence of the amounts paid by Baytown to second tier subcontractors is detailed below in tabular form. The table also illustrates the offsets allowed by the court.

Exhibit	Payee	Amount Paid	Offset Allowed
23	ADS	10,501.00	11,737.46
24	Manholes	2,083.44	3,412.75
25	Sugarland	26,956.64	35,976.33
		39,541.08	51,126.54

The district court, however, relied on Baytown's summary sheets, not the copies of checks in the record (Exhibits 23, 24, and 25), to reach its offset figures. The difference between the amount documented as paid to Rehab's subs ($39,541.08) and the offsets allowed by the court ($51,126.54), is $11,585.46. Baytown does not explain why there is a difference of $11,585.46 between "payments made" to Rehab's subs as reflected on Baytown's summary sheets (Exhibits 3 and 11), and the sums reflected on the only record documentation of payments made to Rehab's subs, Baytown's Exhibits 23, 24, and 25. Baytown had the burden of proving that it was entitled to such offsets.[54] As Mr. Boudreaux admitted that Exhibits 23, 24, and 25 - three checks totalling $39,541.08 - represent the only payments actually made to Rehab's subs, the district court's reliance on the figures on Baytown's summary sheets for "actual pay-

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and Baytown admittedly withheld, i.e., did not pay, at least 2% of claims of ADS, Manholes, and Sugarland and 100% of claims of MACO and Simien, the court disallowed the offsets that Baytown did not actually pay.

54. Baytown asserts that if Rehab wanted to know why Baytown's claimed payments to Rehab's subs were greater than payments evidenced by checks, Rehab should have asked. Such a position by Baytown ignores its burden of proof.

ments" made by Baytown was misplaced. Consequently, to the extent of the difference of $11,585.46, the court's allowance of the unsubstantiated and admittedly unpaid portion as an offset was clearly erroneous.

To recap: Based on the foregoing analysis of the subcontracts and of Baytown's asserted backcharges for overhead, claims costs, and claims by Rehab's subs paid by Baytown, Rehab has defeated backcharges of (1) $476,469.76 for overhead, (2) $59,154.94 for claims costs, and (3) $11,585.46 for claims of Rehab's subs. Rehab has also demonstrated that Finding 10 was $81,243.66 greater than it should have been as a result of the district court's reliance on the wrong subcontract amounts in its calculations. The set-off that Baytown was awarded was $628,453-82 greater than was warranted by the subcontracts and the evidence. Thus Finding 10, the initial $471,411.20 overpayment finding, becomes an underpayment finding of $157,042.62. We conclude then that Rehab is entitled to an affirmative recovery of $157,042.62 on the five COH projects. A question that remains to be addressed, though, is, "Which party - Safeco or Baytown - is responsible for paying that amount to Rehab?"

5. The Judgment.

Safeco, as surety on the payment bonds, is not liable for any portion of Rehab's perfected claims against those bonds. The parties stipulated that, under the McGregor Act, Rehab had perfected only $158,620.04 of its $305,178.69 in claims against the payment bonds. Again, as surety on the bonds, Safeco was entitled to assert all offsets alleged by its principal, Baytown.[55] The district court properly allowed

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55. Aultman & Taylor Co. v. Hefner, 67 Tex. 54, 62, 2 S.W. 861, 864 (Tex. 1886); Robberson Steel, Inc. v. J. D. Abrams, Inc., 582 S.W.2d 558, 564-65 (Tex. Civ. App.-El Paso 1979, no writ).

$179,701.34 of Baytown's asserted offsets. Those offsets ($179,701.34) - which inure to Safeco's credit - clearly exceed Rehab's perfected claims against the payment bonds ($158,620.04). Thus Rehab may not recover any portion of its perfected bond claims.

As for Rehab's breach of contract counterclaim against Baytown on the five COH projects for $336,743.95, Baytown is entitled to apply the same offsets of $179,701.34 applied against the perfected claims on the bonded projects.[56] This time, Rehab's claims are only partially offset, leaving Rehab entitled to an affirmative recovery of $157,042.62 against Baytown on its breach of contract counterclaim. We turn finally to the sole remaining issues, those concerning the award of attorney's fees to Safeco and a possible award of such fees to Rehab.

6. Safeco's Attorney's Fees

Rehab's challenge to the district court I s award of attorneys fees of $92,046.22 to Safeco was limited and conditional: Rehab asserted that if it was entitled to recover on the payment bonds against Safeco, an award of attorney's fees to Safeco under Texas' Uniform Declaratory Judgments Act amounted to abuse of discretion.[57] Thus, as Rehab is not entitled to recover anything from Safeco on its payment

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56. Rehab's breach of contract claims of $336,743.95 relate to all COH projects, projects -2, -7, -8, -9, and 4020-1. Its breach of contract claims relating to the bonded projects total $305,178.69. Rehab perfected only $158,620.04 of its $305,178.69 in claims against the payment bonds issued by SafeCo. Thus the $158,620.04 in perfected bond claims form part of Rehab's breach of contract claims of $336,743.95. Therefore, any offsets applied to the perfected bond claims are also applied to the breach of contract claims.

57. TEX. CIV. PRAC. & REM. CODE ANN. §37.009 (Vernon 1986).

bonds, we need not address whether the district court abused its discretion in awarding attorney's fees to Safeco under the Act. Nevertheless, as we are changing the disposition of this case on appeal, we must determine which party or parties will have to pay Safeco's attorney's fees.

Neither Baytown nor Rehab is clearly the losing party or the prevailing party. The district court, crediting Baytown's testimony, properly allowed Baytown to set-off almost $180,000 of Rehab's claims. But on appeal, we have reversed the district court's allowance of over $625,000 in offsets awarded to Baytown, as a result of which Rehab obtains an affirmative judgment against Baytown. The question of who should pay for Safeco's attorney's fees incurred as a result of the disputed claims and offsets between the parties to this litigation presents a proverbial Gordian knot. Like Alexander the Great, we choose not to struggle fruitlessly in trying to untie that knot, but elect instead to cut it, holding Rehab and Baytown jointly - but not severally - liable. Each is thus responsible to Safeco for one-half of the award of attorney's fees.

7. Rehab Entitled to Attorney's Fees?

Rehab argues that all parties stipulated that the payment bonds furnished by Safeco for projects -2, -7, -8, and -9 were executed pursuant to and governed by the provisions of the McGregor Act. Article 5160(B) of the McGregor Act assures every claimant the right to sue the principal and the surety for the amount due plus reasonable attorneys' fees."[58] As Rehab is not entitled to recover from either Baytown or Safeco on the payment bonds, we need not consider whether Rehab would otherwise be entitled to attorneys'

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58. See TEX. REV. CIV. STAT. ANN. art. 5160(B) (Vernon 1987) (repealed 1993).

fees under the McGregor Act. For, to establish any right to attorney's fees under the McGregor Act, Rehab had to prevail, i.e., to recover on its bond claims under the Act.[59] Here Rehab clearly cannot recover such fees, as it simply was not a successful McGregor Act bond claimant.

III
CONCLUSION

In light of the foregoing analysis and the determinations made therein, we (1) REVERSE and RENDER judgment in favor of Rehab for $157,042.62 against Baytown; (2) AFFIRM the district court's take nothing judgment against Rehab and in favor of Safeco to the extent of Rehab's asserted claims against the payment bonds; (3) AFFIRM the award of attorneys' fees to Safeco in the amount of $92,046.22, but modify the judgment to reflect that Baytown and Rehab are jointly - but not severally - liable to Safeco for such fees, one-half each; and (4) AFFIRM the district court's denial of Rehab's request for attorneys, fees.

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59. J. M. Hollis Constr. Co. v. Paul Durham Co., 641 S.W. 2d 354, 359 (Tex. Civ. App.- Corpus Christi 1982, no writ).

APPENDIX C

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
ENTERED

FEB 24, 1993

Michael N. Milby, Clerk
By Deputy: M. Castro

IN THE UNITED STATES DISTRICT
FOR THE SOUTHERN DISTRICT OF TEXAS
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

SAFECO INSURANCE COMPANY OF AMERICA,	§	
Plaintiff,	§	
V.	§	C.A. NO. H-89-0620
REHABILITATION SPECIALSISTS, INC., BAYTOWN CONSTRUCTION COMPANY, INC., MAR-LEN, INC., MAR-LEN OF LOUISIANA, INC., LEONARD L. MALINOWSKY AND MARION J. MALINOWSKY,	§	
Defendants.	§	

FINDINGS OF FACT AND CONCLUSIONS OF LAW

1. The court has jurisdiction over this action for declaratory judgment under the provisions of 28 U.S.C. §2201 and

under Texas Civil Practice & Remedies Code §37.001 et. seq. because there is an actual controversy between the parties within its jurisdiction, and under 28 U.S.C. §1332 for the reason that the matter in controversy exceeds the sum or value of $50,000.00 exclusive of interest and costs, and is between citizens and residents of different states.

2. Defendant Rehabilitation Specialists, Inc. ("Rehab") is a construction contractor and subcontractor previously engaged in sewer rehabilitation work. Rehab entered into various subcontract agreements with Defendant Baytown Construction Company, Inc. ("Baytown") or Defendant Mar-Len of Louisiana, Inc. ("Mar-Len of Louisiana") as general contractors, whereby Rehab agreed to perform all or a portion of the work on various sewer rehabilitation projects, as listed below:

(1) Project 3783-2
Owner: City of Houston
General Contractor: Baytown

(2) Project 3783-7
Owner: City of Houston
General Contractor: Baytown

(3) Project 3783-8
Owner: City of Houston
General Contractor: Baytown

(4) Project 3783-9
Owner: City of Houston
General Contractor: Baytown

(5) Project 4020-1
Owner: City of Houston
General Contractor: Baytown

(6) Project 3981-1
owner: City of Houston
General Contractor: Baytown

(7) Project Jeanerette, Louisiana
Owner: City of Jeanerette
General Contractor: Mar-Len of Louisiana

3. Between 1986 and 1987, Safeco Insurance Company of America ("Safeco") as surety issued statutory payment bonds on behalf of Baytown, as principal, and in favor of the City of Houston for City of Houston Project Nos. 3783-2, 3783-7, 3783-8 and 3783-9. In connection with Safeco's issuance of the bonds, Defendants Mar-Len, Inc., Mar-Len of Louisiana, Baytown, Leonard L. Malinowsky and Marion J. Malinowsky executed a general agreement of indemnity pursuant to which they agreed to hold Safeco harmless for any loss it may reasonably incur by reason of execution of the bonds.

4. Defendant Rehab made claim against the bonds in the aggregate amount of $336,743.65. Defendant Rehab has dismissed all of its claim against Defendant Mar-Len of Louisiana, Inc. for sums which Defendant Rehab contended it was owed under subcontracts for Defendant Mar-Len of Louisiana, Inc.

5. Defendant Rehab has asserted some claims against Plaintiff Safeco, as payment bond surety for Defendant Baytown, which have not been timely perfected, as required by law and are invalid as claims against the bonds. All parties stipulated that the following claims by Defendant Rehab against Plaintiff Safeco were perfected, to the extent such claims were valid and not subject to defenses, payments, credits, offsets and/or backcharges:

Project	3783-2	$0.00
Project	3783-7	33,836.36
Project	3783-8	46,987.31
Project	3783-9	77,796.37
		158,620.04

6. The Court has heretofore granted summary judgment in favor of Plaintiff Safeco on additional claims asserted against it by Defendant Rehab for breach of a common law duty of good faith and fair dealing, violation of the Texas Deceptive Trade Practices Consumer Protection Act, and violation of Article 21.21, Texas Insurance Code.

7. Plaintiff Safeco has asserted claims against Defendants Baytown, Mar-Len, Inc., Mar-Len of Louisiana, Inc., Leonard L. Malinowsky, and Marion J. Malinowsky as indemnitors on the aforementioned payment bonds.

8. Baytown, as principal on the bonds, has disputed Rehab's claims and alleged certain backcharges which, if valid, would fully offset the perfected claims made by Rehab against the bonds. Safeco is entitled under the law to all defenses asserted by its principal on claims made under the bonds.

9. A dispute exists between the parties over the rights of Rehab, Baytown and the indemnitors, and the duties of Safeco under the bonds, which the parties have been unable to resolve. After a continuing, objective, independent investigation, Safeco has been unable to make a non-judicial determination of the reasonableness and validity of Rehab's claims and Baytown's defenses. Safeco filed this declaratory judgment action so that the court may declare the rights of the parties in connection with Rehab's claims and correspondingly, the duties of Safeco under the bonds. Under the Texas declaratory Judgment Act, Safeco may recover

its reasonable and necessary attorneys' fees incurred in this action. Those fees and expenses have been proved on the record and the Court finds that the fair and reasonable amount thereof, which has not been disputed by the parties, is the sum of $92,046.22.

10. Defendant Baytown is entitled to assert the following payments, credits, offsets and/or backcharges against Defendant Rehab on the following projects as a result of the course of dealing which existed between Defendant Baytown and Defendant Rehab, and Defendant Rehab is not entitled to any affirmative recovery on same (except as to Project 3783-9 to the extent of $22,236.94).

Project 3783-2	48,861.87
Project 3783-7	60,849.67
Project 3783-8	25,505.23
Project 4020-1	25,482.20
Project 4038-1	108,846.11
Project 4040-1	98,878.04
Bacliff MUD	22,838.95
Project 3981-1	102,386.07

Defendant Baytown is not entitled to assert any credits or offsets on Projects 1783-29, 1783-30 or on Maco against Defendant Rehab.

11. The backcharges, payments, credits and offsets of Defendant Baytown against Defendant Rehab exceed the claims for non-payment by Defendant Rehab against Defendant Baytown.

12. Defendant Rehab is entitled to recover nothing on its cross-action against Defendant Baytown.

13. Defendant Rehab is entitled to recover nothing on its payment bond claims against Plaintiff Safeco.

14. Defendant Rehab is entitled to recover nothing on its claim against Plaintiff Safeco for breach of a common law duty of good faith and fair dealing, violation of the Texas Deceptive Trade Practices-Consumer Protection Act, and violation of Article 21.21, Texas Insurance Code, to the extent causes of action against a surety may exist under Texas law, which is a question not reached by this Court in its determination.

15. Baytown, as Principal, and all of the Defendants as Indemnitors, are liable to Safeco for indemnity only to the extent of any valid, unpaid and properly perfected claims by Rehab which are not subject to offsets, credits or payments claimed by Baytown against Rehab.

16. Neither Baytown, as Principal, nor any of the Defendants, as Indemnitors, are liable to Safeco for indemnity for Safeco's attorney's fees, since Baytown has properly defended all claims by Rehab, and since Baytown fulfilled its obligations to Safeco by undertaking to defend Safeco against all claims by Rehab on the payment bonds.

17. Neither Baytown, as Principal, nor any of the Defendants, as Indemnitors, are liable for indemnifying Safeco for attorney's fees or losses resulting from any claims by Rehab against Safeco arising out of breaches of any common law duties of good faith and fair dealing, or deceptive trade practices, or violation of the Texas Insurance Code, or similar claims, because no such causes of action have been recognized against a surety in Texas, and because even if such causes of action do exist, neither the Principal nor the Indemnitors contracted to grant indemnity against such wrongful acts by Safeco.

18. Rehab has retained the Law Offices of William D. Weber, Attorneys at Law, to prosecute this suit and agreed to pay said firm a contingent fee for the legal services per-

formed in the amount of 40% of any recovery on behalf of Rehab. No recovery is due Rehab from any source herein and consequently no fees have been earned by said attorneys herein.

19. Plaintiff Safeco is entitled to recover its fees and expenses, as fixed and allowed and found to be fair and reasonable as determined above, against the Defendant Rehab and Judgment is to be entered against Defendant Rehab for said sum.

20. All costs herein are adjudged against Defendant Rehab.

21. The issues of credibility herein are resolved in favor of Defendants Baytown and the Malinowskys against Defendant Rehab and Rice.

SO ORDERED.

February 24, 1993

Milton Pollack
Senior United States District Judge

APPENDIX D

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
ENTERED

FEB 24, 1993

Michael N. Milby, Clerk
By Deputy: M. Castro

IN THE UNITED STATES DISTRICT
FOR THE SOUTHERN DISTRICT OF TEXAS
SOUTHERN DISTRICT OF TEXAS
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SAFECO INSURANCE COMPANY OF AMERICA,	§	
Plaintiff,	§	
V.	§	C.A. NO. H-89-0620
REHABILITATION SPECIALSISTS, INC., BAYTOWN CONSTRUCTION COMPANY, INC., MAR-LEN, INC., MAR-LEN OF LOUISIANA, INC., LEONARD L. MALINOWSKY AND MARION J. MALINOWSKY,	§	
Defendants.	§	

JUDGMENT

This action came on for trial before the Court, Honorable Milton Pollack, Senior District Judge, presiding, and the issues having been duly tried and a decision having been

duly rendered, it is

Order and Adjudged that:

1. Defendant Rehab take nothing on its claims against Plaintiff Safeco and on its cross-action against Defendant Baytown and the claims and cross-action of Rehab be dismissed on the merits.

2. Plaintiff Safeco recover the sum of $92,046.22 of the Defendant Rehab with interest thereon as provided by law from the date of this Judgment.

3. Costs of the Plaintiff Safeco and of the Defendant Baytown be recovered against Defendant Rehab.

Dated: February 24, 1993

Milton Pollack
Senior United States District Judge